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The Manufacturers Hanover
Economic Report

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Happy Birthday

Notwithstanding all the skepticism that greeted its arrival, as well as the consistent underestimation of its strength and staying power by a number of economists, businessmen and politicians, the current economic expansion has now achieved a milestone of sorts. November marks its third birthday, and if it runs beyond yearend as it seems likely to do, it will become the third-longest post-World War II peacetime expansion. That's not bad for an upswing that many have called weaker than normal and which some economists even wrote off completely earlier this year.

In spite of this impressive track record, there remains considerable confusion and uncertainty over the current and future state of the U.S. economy. A number of economists believe that growth in the current quarter will be much less than that of the third, and of those who don't, many believe that the expansion will run out of steam sometime next year. The October 1985 Economic Report spells out our view of the economy, near-term through yearend 1986, and the reasoning behind it, so I won't go into that aspect here. What I thought might be appropriate, in view of the occasion, is a comparison of the current upswing with its predecessors to see if any further insights into the future can be gleaned.

A Comparison With The Past . . .

As the table inside indicates, the gain in the gross national product adjusted for inflation has, indeed, been weaker than average. In fact, it has been weaker than average in almost every quarter since it began. What is more, the gap between the current expansion's GNP path and those of its predecessors has been widening in the last year.

However, this includes wartime periods, which tend to prolong expansions. A comparison with peacetime upswings only produces a more favorable result. What is more, the real GNP is only one way of measuring the state of business. As its name implies, it describes the output side of the economy. Another way to look at things is through the spending side and here the comparison is quite different. Domestic demand adjusted for inflation grew slightly less than average over this recovery's first year of life—but starting in first-quarter 1984 it has been consistently stronger and is now well above the postwar peacetime average. Of course, the difference between real domestic demand and the real gross national product is our trade balance, which, as you know, has been much worse than average. Three years into comparable business recoveries would find exports in real terms up by 25 percent; in the current expansion they are barely one percent above their end-of-recession levels. Imports, on the other hand, have risen 57 percent, while in past recoveries they were up an average of only 22 percent. This turnaround reflects the changed value of the dollar. At its peak earlier this year, the dollar was 27½ percent above its level at the end of the last recession compared with an average increase of barely two percent in the past.

One of the more confusing pictures is painted by the labor situation. Depending on one's point of view, it is possible to be either concerned or enthused when looking at the behavior of unemployment and employment during the current recovery compared with the past. For example, at 7.1 percent, the civilian unemployment rate is 2½ percentage points higher than its average at this point in past business recoveries. However, the decline in the unemployment rate since the end of the last recession, 3½ percentage points, is so far greater than the average of 2⅓ percentage points. Of course, it started out higher in this upswing.

Turning to employment, the number of people working has climbed by about nine percent so far in this expansion compared with an average rise of 7½ percent. However, not all sectors have shared in this gain. After keeping up with the postwar average for the first two years, factory payrolls have since declined to the point where they are only about seven percent greater than they were at the end of the last recession compared with a

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postwar average increase of nearly 11 percent. By contrast, employment in service industries has grown much faster than average, 16½ percent versus 12⅓ percent. Government employment, on the other hand, has grown much more slowly than average, four percent versus 10½ percent. Finally, the employment rate (civilian employment divided by the noninstitutional population over the age of 16) is now at a postwar peak of 60⅓ percent.

. . . Reveals Strength In Consumer Spending . . .

In view of this strong growth in employment, it would be reasonable to expect personal incomes growth to be strong as well. Unfortunately, this is not the case. By previous standards, the 22 percent rise in personal incomes so far in this recovery is weak, since the average gain is over 29 percent. This traces to several factors. Wage and salary disbursements are up less than average, reflecting a need on the part of many businesses to hold the lid on costs due to the inability to raise selling prices that has accompanied the reduced rate of inflation. Foreign competition has also played a role, as has the fact that much of the job gains has come in lower-paying service industries. Another reason for personal income's weakness is interest income. After rising much faster than average by the middle of 1984, interest income has since declined. Of course, it should be noted that the level of interest income is much higher today than in the past.

This slowdown in nominal income growth has more than offset the cut in personal taxes and the slowing of the rate of inflation that has occurred this time around. As a result, buying power (take-home pay adjusted for inflation) is up only 1⅓ percent, year-over-year, compared with an average gain of 4½ percent. In fact, the four-quarter increase in buying power today is almost as small as it was at the end of the last recession. In the face of this, people have increased their outlays at a faster rate this time than they did on average in the past. Personal consumption expenditures adjusted for inflation are up over 14 percent so far in the current expansion compared with an increase of little more than 12 percent. What's interesting here is that total consumption has been pushed upward faster than average by spending on goods as opposed to services.

If personal incomes are growing more slowly than average while personal consumption is rising faster than average, it has to show up in terms of use of credit and in the level of personal savings—and it does. Consumer credit outstanding is now 60 percent above its level at the beginning of this recovery compared with an average growth rate of 42¾ percent. As a share of take-home pay, consumer credit outstanding is currently at a record. Not surprising, the reported savings rate is far below average. Whereas the savings rate at this point in the typical postwar recovery was one percentage point above its level at the end of the past recession, today it is nearly three percentage points below.

Considering the damage that the strong dollar is supposed to have done to the goods-producing sector of the U.S. economy, it is interesting to note that growth in industrial production so far in this recovery, over 24 percent, is not far below other comparable recoveries whose average comes out to 27½ percent. However, back in the middle of 1984, growth in industrial production was nearly four percentage points greater in the current recovery than in the average of the previous ones.

gap compared with the past is true for both equipment as well as for structures. It seems to be a byproduct of several developments. First of all, the jumping off point was extremely low, since the drop in output of business equipment during the 1981-82 recession was not only nearly twice as great as average, it was the worst decline in the postwar era. Second, the Economic Recovery Tax Act of 1981 made it extremely lucrative for business to invest in new capital goods, once the recession ended and demand revived. But while producers of structures have benefited from the better than average increase in spending on factories, office buildings, warehouses, shopping centers and the like, manufacturers of business equipment have increasingly been left at the starting

COMPARING POSTWAR BUSINESS EXPANSIONS

	Duration in months	% Change in Real GNP	% Change in Real Domestic Demand	% Change in Real Exports	% Change in Real Imports	Lowest Jobless Rate	% Change in Real Personal Consumption	% Change in Real Business Fixed Investment	Point Change in Consumer Price Inflation	% Change in Dow Jones Industrial Average
Oct 1945 – Nov 1948	37	NA	NA	NA	NA	NA	NA	NA	NA	NA
Oct 1949 – Jul 1953*	45	27.2	28.2	19.5	46.1	2.5	12.7	31.0	3.0	45.0
May 1954 – Aug 1957	39	13.2	12.5	32.7	18.3	3.7	13.4	22.8	2.6	51.1
Apr 1958 – Apr 1960	24	10.2	10.1	15.1	14.1	4.8	9.5	15.3	1.6	38.7
Feb 1961 – Dec 1969*	106	47.2	49.0	71.2	125.4	3.4	46.2	80.1	4.5	21.4
Nov 1970 – Nov 1973	36	16.7	15.2	45.5	21.6	4.6	13.8	27.6	2.6	14.3
Mar 1975 – Jan 1980	58	24.3	23.4	58.1	59.2	5.6	22.9	42.3	3.6	12.5
Jul 1980 – Jul 1981	12	4.0	5.0	1.9	15.4	7.2	2.8	8.9	–2.5	4.2
Average—all expansions	45	20.4	20.5	34.9	42.9	4.5	17.3	32.6	1.7	26.7
Average—peacetime	34	13.7	13.2	30.7	25.7	5.2	12.5	23.4	0.9	24.2
Average 1st 36 months	36	16.2	14.3	24.6	21.5	4.7	12.4	20.4	1.3	28.3
Nov 1982-to-date	**36**	**14.2**	**18.7**	**1.0**	**56.7**	**7.0**	**14.4**	**35.1**	**1.3**	**31.5**

*wartime
NA: Not available

. . . And In Business Investment . . .

Not surprising, capacity utilization in the key manufacturing sector is far below average. Three years into the previous recoveries which lasted this long found capacity utilization averaging more than 85 percent. Today it is 80 percent—down from 82 percent in summer 1984. One reason for this decline can be seen in the efforts of manufacturers to trim their inventories. At this point in past recoveries the inventory-sales ratio in manufacturing averaged 1.64. Today, because of higher real rates of interest and more efficient computer-run controls, the ratio stands at only 1.47.

In the face of this, growth in business investment has been much greater than average. Real business fixed investment today is 35 percent higher than it was at the end of the last recession, whereas it stood 20½ percent higher in the five previous comparable recoveries. This gate because of the strong dollar. More than one-fifth of all business equipment purchases last year came from overseas; in 1970, only one dollar out of every 16 that was spent on business equipment went abroad.

The government is exhibiting diverse trends. On the one hand, government spending as a share of gross national product is higher today than in the past—to no one's great surprise. Meanwhile, government revenues are expanding much more slowly than they usually do at this point in a business recovery. At the Federal level, adjusted for inflation, the rise in government revenues so far is eight percent compared with over 22 percent in past expansions. Obviously, this reflects the combination of the tax cut of 1981 and the slowdown in the rate of inflation. Of course, the Federal government's budget deficit dwarfs its level at this point in previous recoveries, both nominally and in real terms.

. . . While Inflation Is Down Markedly

As has been observed previously, inflation looks much better today than it has in the past. The most recent 12-month change in the consumer price index, 3¼ percent, is far below the average for this point in a business recovery of 4½ percent. What is more, in past recoveries this rate was inching up whereas this time around, it has been moving down since the early part of 1984 following a brief increase. In fact, the 12-month rate of consumer price inflation today is 1⅓ percentage points less than it was at the end of the last recession whereas in the past it averaged 1⅓ points higher.

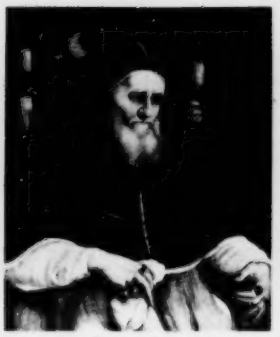
Notwithstanding the better than average showing for inflation, interest rates remain higher than average both in nominal and in real (adjusted for inflation) terms. The 3-month Treasury bill rate today averages about 7¼ percent compared with an average of 4½ percent in the previous recoveries. The real rate on T-bills today is nearly four percentage points compared with zero in the past. The same comparison is true when one looks at bond yields. At 11½ percent, AA utility bonds are about five percentage points above their postwar average. After subtracting inflation, the gap is even wider: 8½ percent versus 1½ percent.

Rather than focusing on the improvement in the inflation rate, the markets are apparently looking more at economic policy in determining the cost of short- and long-term money. The budget deficit is one part, the money supply is another. And so far in this expansion the money supply has grown much faster than it has in the past. The level of the money supply is 28 percent higher today than it was at the end of the last recession compared with growth of 14 percent in the past.

Perhaps the best way to sum up this comparison is to see what Wall Street thinks. The Dow Jones industrial average usually goes up during a business recovery and this time is no exception. In the beginning the Dow more or less tracked its past performance. However, early in 1984 stocks took a header, putting their cumulative growth by the middle of that year well below postwar averages. However, stocks soon got their second wind and are now up about 32 percent since the end of the last recession compared with a 28 percent average rise in the past.

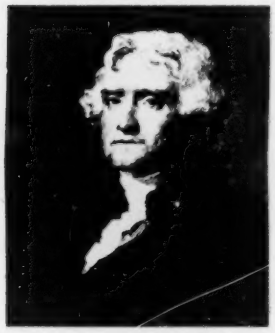
In my judgement, one should not write this recovery off just yet. It is stronger than it looks and is not as out of shape as some think. What is more, events that have already occurred, such as the drop in the value of the dollar, the decline in interest rates and the surge in money growth, along with the liquidation of inventories in many lines of business, suggest that 1986 may turn out to be a lot better than many now anticipate.

15th Century: Lorenzo de Medici and his family lead the cultural flowering of Florence.



1508: Pope Julius II commissions Michelangelo to paint the Sistine ceiling.

1717: George I is honored by the composition of Handel's *Water Music*.



18th Century: Thomas Jefferson becomes a noted patron of the arts.

1829: James Smithson of London bequeaths his fortune to the U.S. to establish a museum.

1892: Andrew Carnegie provides the funds to build Carnegie Hall.

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